5 Views of Capital and Virgin

Contents

Page

Capital's bid for Virgin 85
Capital: background and reasons for the bid 85
Virgin's acceptance of the bid 86
Competition in UK radio 87
The role of the Radio Authority 87
Digital radio 87
Competition with the BBC 88
Competition in London 88
Capital's plans for Virgin FM and AM 89
Competition for advertising revenues 90
Competition between radio stations in London 91
Competition between radio and other media 91
The planning and buying of advertising campaigns 93
Planning a campaign 93
Buying a campaign 93
Advertising prices 95
The future of other London ILR stations 96
Possible benefits of the merger 97
Possible remedies 98
Summary 99

Capital's bid for Virgin

Capital: background and reasons for the bid

5.1. Capital commented that for the first 18 years after its foundation in 1972 its principal business activity was radio in London. Following the introduction of the 1990 Act, which further deregulated radio ownership, Capital acquired existing stations in the Midlands and along the south coast, in order to reduce its commercial reliance on London.

5.2. The period since the passage of the 1990 Act had been marked by consolidation of radio stations into four major (and a number of minor) groupings and by a fall in Capital's audience and revenue market shares, especially in London. Further deregulation, introduced by the 1996 Act, recognized the convergence of formerly discrete media within the transition to a new digital era and accordingly relaxed previous ownership constraints both within and across media. In particular, ILR station operators were permitted to hold three licences in one area, provided that these included both an FM and an AM licence, and subject to a public interest determination by the RA (see paragraph 4.21). As a result, in 1996 Capital applied for an FM licence for its London AM station, Capital Gold. However, the licence, which was understood to be the last one available for London, was awarded to Xfm.

5.3. Capital next considered the possibilities of acquiring a second FM licence in London and informal discussions were held with a number of parties, including Virgin Holdings. Capital explained that since the early 1990s it had based its strategy on growth in UK radio by fostering an increase in radio's share of total display advertising revenue and by acquiring radio companies capable of improved performance. It said that, after evaluating the options, Virgin Holdings was considered the most appropriate strategic fit and was approached.

5.4. Capital said that the primary interest in acquiring Virgin was the opportunity to own a second FM station in London following the change in legislation. Capital was a customer-focused business and its London radio stations were already the centrepiece of the Capital group. Importantly also, the acquisition would enable Capital to develop further its core skill base, in line with its future strategy. With regard to the national situation, given that Capital's core business in radio was popular music, there was really no opportunity for Capital at present other than to bid for Virgin AM. However, this might change with the arrival of digital radio (see paragraph 5.10).

Virgin's acceptance of the bid

5.5. Virgin told us that it believed it was inconceivable that radio would remain an analogue medium whilst all other media switched to digital services. However, for DAB to succeed, substantial investment would be required to create momentum in the market place. This requirement for investment had, at least initially, been underestimated by Virgin. So too had the need for greater resources in terms of programming skills.

5.6. Initial costings suggested that a national DAB transmission network would cost some £7 million to £9 million to set up, plus £1 million to £1.2 million a year for each service operated. For a private company with Virgin's resources these were significant costs. The company was still in cumulative loss and, at least initially, DAB would generate no additional revenue. In addition, however, the scale of the marketing and promotional costs that would be required to establish DAB was not immediately apparent—it now appeared that radio broadcasters, in common with their television counterparts, would need to come together and subsidize the digital receivers, in addition to funding traditional marketing activities, in order to 'kick start' the market. Virgin's concerns were further reinforced by the progress made in developing DAB by the BBC, which had already invested over £10 million.

5.7. Virgin pointed out that the three existing INR stations, including Virgin, had an automatic right to a slot on the national commercial DAB multiplex; further, on taking up—or, in the case of the local multiplexes, winning in competition—a DAB licence, an independent radio station was to be automatically granted a rollover of its analogue licence. As the Government intended, this was a powerful incentive for all independent stations to invest in DAB.

5.8. Virgin said that, for its part, it had been an enthusiastic supporter of DAB despite its own limited technical resources. For example, it had run a number of test transmissions in Birmingham and London and had also begun to address the marketing of the new waveband through its 'FAB DAB' campaign. However, Virgin was now quite highly geared as a result of taking up loans to buy out its minority shareholders (see paragraphs 3.30 and 3.33) and was unlikely to be able to increase its bank borrowings in the short term. In addition, there was clear room for improvement in Virgin's programming skills and Capital had been demonstrably successful in that area. The proposed merger with Capital would create a strong INR group with the resources and skills to compete with the BBC in DAB and to provide a catalyst for the further development of a successful UK commercial radio industry. A number of other parties which might be interested in acquiring Virgin had come forward when the proposed merger with Capital was first announced, and again when it was referred to the MMC; on 12 November a competing bid was received, from Ginger Productions, to which Virgin was giving serious consideration. Nevertheless, Virgin said, it was continuing discussions with Capital and may still proceed with the proposed merger, subject to the approval of the Secretary of State for Trade and Industry.

Competition in UK radio

The role of the Radio Authority

5.9. Capital commented that the RA had been charged, under the 1990 Act, with appointing licensees with a view to broadening listener choice. There were now some 200 licensed commercial radio services in the UK, including three INR stations (see paragraph 4.4). Most recently, Xfm had launched across London with a marketing budget claimed to be £1.5 million and, Capital believed, a target of 750,000 listeners a week. In addition, there was Atlantic 252 broadcasting from the Republic of Ireland under a local Irish licence, five BBC national and 39 BBC local English radio stations, 18 cable and 28 satellite radio services. The RA was in the process of advertising and issuing further licences in 22 areas, including three regional licences and 11 'sallies' of which one was for south-east London. The RA had also consulted on proposals to advertise a fourth INR service (see paragraph 4.55). In its public interest assessment of Capital's proposed acquisition of Virgin (see paragraph 4.23), the RA had concluded that, subject to certain undertakings which would reinforce the diversity of output, it saw no reason in terms of plurality of ownership or diversity of output to disallow the acquisition.

Digital radio

5.10. Recently the RA had announced that digital radio multiplex licences would be advertised in the spring of 1998 in order for the first digital services to be on air in 1999. The national multiplex licence and the first batch of local licences would be advertised in close succession as part of the RA's 'fast-burn' approach designed to bring as many new digital services as possible on air at the same time. This could result in many key areas of the country receiving more than 20 digital radio programme services, alongside an array of text and data services, before the end of the millennium. Within London the competition for listeners would increase significantly: at present, seven of the 15 London-wide London-based radio stations broadcast on the inferior AM waveband, whereas all 15 could be broadcast in CD-quality sound once digital radio was introduced. Whilst Capital envisaged a slow take-up of DAB as receiver costs declined, when DAB succeeded broadcasters would face greater competition still from new BBC and commercial radio stations. Over time, improvements in compression technology would probably allow many more radio stations to be launched, both commercially and by the BBC, within the band width presently allocated to terrestrial radio broadcasting.

5.11. Capital considered that its own position within London might be undermined within the increasingly competitive environment introduced by digital radio, for a number of reasons. First, multiplex applicants did not have to name the specific services they would broadcast; this could only work against the established radio operators since similar programming formats to theirs might be provided by any of a multitude of other radio companies, including some under foreign ownership. Secondly, it was likely that there would be a large number of applicants to run a London multiplex and Capital was guaranteed neither a multiplex licence nor a place on any multiplex. Thirdly, it was not inconceivable that the RA would not award Capital a multiplex licence but merely a programming licence enabling Capital's services to be among those provided by any successful multiplex applicant. Finally, as a mere programme provider Capital stood to lose the competitive advantage it had won through its consistent investment in making 95.8 FM the best-known frequency in London, because the ease of retuning digital radios would mean that there was no need to remember the station frequency.

5.12. Capital added that its own ability or desire to exclude competitors such as Heart or Xfm from a multiplex would be negligible. The 1996 Act required the RA, in awarding a multiplex licence, to have regard to the question (among others) whether the applicant had acted in a manner calculated to ensure fair and effective competition in the provision of services. Moreover, Capital would be seeking to include strong and popular analogue radio stations in order to encourage the take-up of digital receivers. Capital reiterated that its foremost objective was to drive radio forward as an advertising medium. To exclude important broadcasters from digital radio would jeopardize the achievement of that objective.

5.13. Virgin told us that it considered digital technology the key to the future of broadcasting. Although the RA had recognized the importance of DAB and would be implementing what it termed a 'fast-burn' licensing process (see paragraph 5.10), Virgin did not believe that many participants in commercial radio realized either the potential scale of DAB or the relative speed with which it was likely to become established. Just as today FM had widely replaced AM, within a few years DAB would be the dominant waveband in the place of FM and AM. On the national commercial multiplex there would be capacity for six to eight channels, compared with the existing three licensed INR stations and Atlantic 252. In the London area, whilst initially there might be insufficient capacity to carry all the existing analogue stations, probable improvements in compression technology and, perhaps, the availability of additional spectrum made it entirely feasible that within five years or so there would actually be greater capacity for programmes than at present. Virgin indicated that it intended to be involved in the national commercial multiplex, in one way or another, regardless of the outcome of our inquiry, in order to secure the automatic rollover of its analogue licence as provided by the Government.

Competition with the BBC

5.14. Capital observed that total radio listening in London, including both the commercial sector and the BBC, had been comparatively stable for some time. The main battle was therefore to continue to take listeners from Radios 1, 2, 3, 4 and 5 and perhaps also the BBC's World Service and GLR. In addition, it was notable that the BBC had of late been in competition for sponsorship advertising expenditure.

5.15. The proliferation of commercial services after 1990 had led to listeners being won from the BBC. However, the biggest gains by the commercial sector had occurred between 1993 and 1994 when Radio 1 was radically revamped to increase the 'public service' element of its programming in preparation for the review of the BBC Charter in 1995/96. The worst of the decline in the Radio 1 listenership had been mitigated by the employment for a time of a popular presenter for the critically important breakfast show. Radio 1 was now overtly targeting 15- to 24-year-olds and had announced the launch of a new digital television service dedicated to Radio 1. In addition, new presenters of the breakfast show would be widely publicized on BBC television and elsewhere and the BBC had recently appointed a Marketing Director with a specific brief to increase BBC radio's audiences.

5.16. Capital and Virgin pointed out that, unlike independent radio stations, the BBC was not constrained by any promise of performance and benefited greatly from its ability to cross-promote between its radio and television stations. Radio 2, having revised its programming over the last four or five years to mount a more concerted national FM challenge to the Gold AM formats of commercial broadcasters, had become the most popular radio station in the country. Radio 4 was currently being reprogrammed to increase its appeal to younger listeners, amid much public ado. The competitive threat posed by the BBC was enhanced by the scale of its marketing budgets and its ability to attract and reward some of the best talent available. The BBC also had the guarantee of inclusion on DAB multiplexes at both national and local level.

5.17. Virgin considered that, in time, with improvements to its programming, Virgin FM could considerably increase its share of listening. However, much would depend on the success of the measures taken by the BBC, since most of the anticipated growth would come from attracting current BBC listeners.

Competition in London

5.18. Capital commented that the first commercial radio companies had benefited from the particular way in which the independent sector had developed. This was because in most regions of the country the first commercial stations had been popular music 'chart' services which tended to attract the largest audiences, while subsequent services had broadcast other less popular music formats or speech services. Those companies first into the field had tended to adopt the chart format for their FM service and the Gold format (chart successes of former years) on AM, these being generally the two most popular formats. Partly for these reasons, Capital FM and Capital Gold were the two biggest ILR

stations in London, although the increasing number of competitors during the 1990s had caused a decline in their audiences.

5.19. Capital said that it expected the decline in its audiences to continue as more new ILR stations were launched and the BBC sought to recover its lost audience share. In addition, Kiss 100 FM, Melody, Sunrise, Jazz and Spectrum, all established London-wide services, had served their audiences well since the start of the present decade, offering diversity to London listeners. Kiss 100 FM competed directly for Capital FM's core of younger listeners and the amount of overlap was steadily increasing as Kiss 100 FM sought to make its dance music more competitive. Melody was an 'easy-listening' station targeted primarily at the over-35-year-olds, a significant proportion of the population (over 60 per cent); it was consistently the third most popular ILR station in London. Jazz had a broader promise of performance than its name might suggest and focused on an audience of ABC1 35- to 54-year-olds.

5.20. Capital said that the launch of the London-wide stations Heart and Virgin FM in 1995 represented a particular challenge to Capital FM as their promises of performance allowed them to target similar audiences and age groups. Heart, in particular, enjoyed a promise of performance that enabled its musical output to be closer to Capital FM's than any other commercial radio station; in Birmingham, where the Heart format had been launched in 1994, the station had already made considerable inroads into the audiences of the Capital-owned BRMB FM and Xtra AM, the local popular music and Gold stations. Virgin FM, in the event, had failed to deliver the focused, recognizable rock sound that an impatient audience expected and now had a credibility problem that was reflected in its audience figures.

5.21. Capital told us that it had worked to build Capital FM, over time, to its present position in the market place as a revered radio station. However, with every quarterly set of RAJAR statistics it had to redouble its efforts to maintain that position as competition in the market place took increasing effect. Xfm's entry to the market on 1 September 1997 offered further direct competition with Capital's and Virgin's London stations, with all of its programming focused into a musical subset of Capital FM's and Virgin FM's promises of performance. Furthermore, stations with formats substitutable for Capital's were owned by major corporations such as Hanson plc, EMAP and Chrysalis Group, owners of Melody, Kiss 100 FM and Heart respectively. All of these were eminently capable of funding aggressive competitive behaviour towards Capital if they so chose.

5.22. Virgin told us that it attributed the decline in its audiences partly to competition and partly to other factors which had proved difficult to identify. Virgin's research indicated a significant loss of listeners in London to the BBC and losses also to Heart, Kiss 100 FM, Melody, Capital FM and other commercial stations. Heart had 77 per cent of its audience in Virgin FM's core market of 25- to 44-year-olds. Both Capital FM and Kiss 100 FM had 60 per cent of their audiences in this market—Kiss had originally targeted a very young audience keen on dance music, but many of its listeners were now aged 20 to 35. Melody, which Virgin would not have regarded as a competitor three years ago, had since broadened its appeal and doubled the proportion of its listenership in Virgin FM's core market. In Virgin's opinion, Xfm's audience figures and profile would follow the same pattern as in the case of Kiss 100 FM, starting very young before broadening and ageing and reaching ultimately around a million Londoners.

Capital's plans for Virgin FM and AM

5.23. Capital told us that it intended to invest in Virgin on a greater scale than the present owners, applying its programming and sales skills to enhance Virgin's attractiveness to listeners and advertisers. In particular, Capital proposed to end the current arrangement whereby Virgin FM and AM shared their programming for all but nine hours each weekday. Instead, Capital would create a separate station on 105.8 FM targeted specifically at Londoners, and a revamped Virgin AM with its own national distinctive style. The output of the London station would be adjusted to sharpen its differentiation from the other London stations, while Virgin AM would be designed to compete head-on with Radio 1.

5.24. The target audience of Virgin FM would be 25- to 44-year-olds and male. The music would basically be rock, much of it contemporary guitar-based rock by mainstream bands formerly in the independent sector: today's 'indie' band was tomorrow's mainstream band, so there was a great deal of modern material available to choose from. This would be backed by top-class presenters focusing specifically on the target audience. Alternative comedians would be used so that the whole radio station would become a complete entertainment appropriate to its target audience.

5.25. As regards potential competition between Virgin FM and Xfm, Capital said that Xfm's promise of performance required that 80 per cent of its music must have been released in the past three months. In addition, Xfm played a good deal of music that would not be available to buy in the shops until about six months later. This would be entirely inappropriate for Virgin FM. Both Capital and Virgin pointed out that, in any event, the RA had determined that the promise of performance of the Capital-owned Virgin FM should be varied to reduce the maximum amount of alternative rock permissible on Virgin FM from 32 to 20 per cent. This was with the specific intention of differentiating Virgin FM from Xfm and reducing the likelihood of potential competition between them. Capital told us that there was no question of Virgin FM under Capital's control having a similar music policy and therefore appealing to Xfm's core target market.

5.26. Capital commented that Virgin FM would be, by its remit, more of a niche station than Capital FM or Capital Gold. Until now Virgin FM had failed to achieve any product consistency; indeed it had employed four different programme controllers in four years. By contrast, Capital would set out to be consistent from the beginning. However, this would probably entail an early loss of listeners, in the interests of establishing the long-term audience required for Virgin FM to achieve the success that Capital envisaged. The impact on Capital Gold would probably be negligible. The effect on Capital FM was less certain, since current listeners might well want to try Virgin FM if it was a successful product and some of them might cross over as they aged a little and, perhaps, preferred Virgin FM's brand of humour. However, the potential impact on Capital FM would probably amount to no more than 2 to 3 per cent in terms of market share.

5.27. As regards Virgin AM, Capital said that this would be targeted at 15- to 34-year-olds nationally and would be a guitar-based pop rock station. Since Virgin AM and FM had shared their programming, listeners nationally had been more or less disenfranchised. Broadcasting in London as well as nationally, Virgin AM had not spoken with any particular voice—if anything, rather more of a London voice. Virgin AM had failed to offer a consistent product and had been unable to generate a strong, loyal listenership. Capital would go back to square one, within the present promise of performance, and set out to entertain 15- to 34-year-olds who, broadly speaking, shared the same tastes and interests as each other. However, while competing directly with Radio 1, Virgin AM would not play the same music as Radio 1 was currently broadcasting, nor would it, like Radio 1, be punctuated by a great deal of speech once the breakfast show was over. Virgin AM would create brand new listener choice, a fast-flowing musical service that was straight entertainment for 15- to 34-year-olds.

5.28. Capital said that it was keen to attract listeners in areas across the country where there was a good AM signal, but hitherto poor radio coverage in terms of services with any real popular appeal. Overall, Capital expected not only to halt and reverse the decline in Virgin AM's listenership but, over time, to grow Virgin AM's market share. Further, once Virgin AM and Radio 1 became available on digital radio, that would allow competition between them both on a more even basis.

5.29. In summary, Capital and Virgin said that the creation of a new dedicated FM rock station for London and a reformatted and relaunched national AM station would provide increased choice for listeners. They expected these improvements in programme quality to provide wider diversity of choice and complement existing commercial radio services.

Competition for advertising revenues

5.30. Capital stated that competition for advertising revenues was growing continually, both between radio stations and between radio and other media. It said that this was particularly true within London, where there was a proliferation of media choice.

Competition between radio stations in London

5.31. Capital told us that it was now consistently losing revenue share, as well as audience share, in London as competitor stations gathered momentum. In the two years to 31 December 1996 its share of London revenue had declined from 65.8 to 60.9 per cent. Capital forecast (with the benefit of ten months' actual results) that by 31 December 1997 its share would have fallen to [*] per cent; and that its declining audiences would result in a share of [*] per cent by 2002. Capital said that it had sustained its revenue share for as long as possible by attracting new advertisers to radio at the expense of other display advertising media. Indeed, since 1992 it had been one of Capital's main corporate objectives to increase advertising revenue by taking sales from other media.

5.32. Capital reckoned as a rule of thumb that a radio station offering around 5 to 10 per cent coverage of its target audience was attractive to advertisers. Success in winning advertising revenue initiated a virtuous circle, enabling investment in better programming, leading to higher coverage and hence increased demand from advertisers. Capital said that it had provided this critical mass of audience coverage and that other radio stations had benefited from its lead, attracting advertising budgets of quality at rates higher than those they would be likely to have achieved in the absence of Capital.

5.33. Conversely, Capital pointed out that the growing number and strength of commercial radio stations had benefited Capital, by increasing the audiences accessible to advertisers by radio and hence contributing to a growth in radio's overall share of advertising revenue. In addition, new stations provided a continuing stimulus to good programming and introduced new ideas and techniques. Capital said that its acquisition of Virgin would not upset this, but rather would help all London commercial radio stations cope with the expected further increase in competition, particularly from the BBC. Furthermore, the concentration of ownership of commercial radio audiences within London would remain lower than in any other major metropolitan area in the UK.

Competition between radio and other media

5.34. Capital and Virgin argued that radio formed part of the broader display advertising market. Capital said that consumer exposure to display advertising was higher in urban areas and at its highest in London, which, apart from the highest number of radio stations, supplied the largest number of commercial television stations; a proliferation of 280 local newspapers, 65 London magazines and a further 72 publications in which advertisers could buy London/regional opt-outs; 29 per cent of all UK cinema admissions; and over 30 per cent of all roadside panels plus more than 140,000 panels on the London Underground.

5.35. Capital stated that between 1977 and 1997 (Quarter 2) commercial radio had grown to a 60 per cent weekly reach and half of all listening hours in the UK. This had created a strong position for commercial radio companies to compete for higher shares of display advertising revenue. Between 1992 and 1996 radio revenue across the UK had more than doubled and its share of all display advertising revenue had grown from 2.8 to 4.7 per cent. Over the same five-year period the London market had displayed similar steady growth in radio revenue. Further, the marketing and programming efforts of longer-established ILR stations such as Capital, together with the higher reach generated by the increasing number of newer stations, had resulted in commercial radio taking a higher than average share of display advertising revenue in London.

5.36. Capital said that of the £7 billion or so spent annually on display advertising in the UK, approximately £1.6 billion was spent in London. This reflected the attractiveness of the demographic characteristics of the London population to advertisers, which contributed to higher media prices than in the rest of the country. Of the total London display market of £1.6 billion, radio advertising accounted for £75 million.

---

*Figures omitted. See note on page iv.

5.37. Capital and Virgin argued that the increase in radio's share of the wider display market indicated that advertising which had previously gone to other media had been replaced by radio advertising. In addition, Capital provided us with a report prepared by Case[1] which it considered contained ample statistical evidence of substitution by advertisers between radio and other media. Capital also submitted that this report showed the proportion of advertising revenue spent on radio as against other media varying considerably over time. It believed this strongly suggested that radio and other media were mutually substitutable, particularly in those business and product categories where radio was most in demand. Indeed, this was borne out by the experience of Capital's own sales team, which suggested that price played a leading role in advertisers' decisions to switch spend among media. Finally, said Capital, this report also showed that many advertisers used multimedia campaigns, the components of which they varied from one year to the next. Subsequently, Capital supplied us with a second report from Case[2] (see paragraphs 4.91 to 4.93) which, it submitted, backed up Capital's business experience that other media significantly constrained advertising prices on Capital FM and that advertisers could and did readily switch between media on price-related grounds.

5.38. Capital told us that it was far from suggesting that all radio competed directly with any particular medium or all media for all display advertising in all circumstances. However, there was clear evidence that a substantial proportion of the £1.6 billion display market in London was contested both by radio and by other media. This competitive overlap need not be very large—if a further £75 million of the £1.6 billion were competitive with radio this would halve Capital's market share in London—for Capital's relevant market share to be modest before and after the merger, and certainly not such as to indicate that acquiring Virgin would give it greater market power. Capital believed its relevant market share should be calculated on this basis.

5.39. Virgin endorsed Capital's arguments and said that the importance of recognizing the real market in which radio advertising competed could not be overstated. It acknowledged that, whilst radio did not compete with all other media all of the time, it did compete with all other media some of the time. What would be important for the MMC to decide was the degree of overlap.

5.40. Capital said that it regarded both other media and other radio stations as its main competitors. In line with its mission to grow the radio advertising market, it competed with other media to try and win a share of the total display market for radio; once it had won a share for radio it aimed through negotiation to secure a profitable amount of that expenditure for itself. It added that smaller ILR stations, too, competed with other stations targeting similar audiences and with relevant other media, such as specialist magazines, local newspapers, transport or poster advertising and cinema.

5.41. Capital believed strongly that commercial radio's share of all display advertising expenditure was capable of further growth. It said that this view was shared by the RAB, other radio companies and independent commentators. The present commercial radio share of about 5 per cent in the UK compared with an average of 6 per cent for Europe as a whole, 8 to 9 per cent in the USA and 10 to 12 per cent in Australia. Views in the industry were that a target of 8 per cent in the UK was achievable by 2010.

5.42. Virgin firmly believed consolidation by merger with Capital would help to grow radio as an advertising medium. In Virgin's view, this merger and the formation of stronger, in-house sales points out of Capital's disbandment of MSM's wholesaling operation marked the beginning of the next phase of consolidation in radio advertising sales which was necessary to drive the medium forward. Radio had grown impressively from a 2 per cent to almost a 5 per cent share of display advertising, but this share was capable of development up to perhaps 8 per cent or even 10 per cent, provided that there emerged probably no more than four or five strong, competing groups of sufficient size and professionalism to promote radio as an advertising medium and win audience share from the BBC through their superior programming skills. Capital commented that what appeared to happen, in any event, within the context of the regulatory framework operated by the RA was that fragmentation flowing from the issue of licences to new entrants was superseded by consolidation as the major radio groups such as Capital, EMAP and GWR subsequently bought the licences from the successful applicants.

---

[1] *Advertising Media Substitution—An Empirical Analysis*, 1 September 1997, Case Associates.

[2] *Price Analysis of Inter-Media Substitution*, 17 October 1997, Case Associates.

The planning and buying of advertising campaigns

Planning a campaign

5.43. Capital provided us with a paper by Unity, a media planning consultancy. This paper described the planning of an advertising campaign as a craft, producing subjective recommendations based on experience and judgment as much as hard data; for each task a notional value for each medium was balanced with the broad market price for that medium. The result, according to the paper, was a highly substitutional media market, and one in which, at both the planning and the buying stages of the process, price was an influential factor. Capital also told us that there was a growing trend for advertisers to use secondary media, that is one, some or all of radio, posters and cinema, as well as the primary media, television and the press, although the primary media continued to take a dominant share of display advertising revenues. Nevertheless, Capital submitted, price negotiations at the implementation stage of a particular campaign could result in radio winning a higher or lower than anticipated share (as the case may be) of the overall budget relative to the other secondary media or the primary media.

5.44. Virgin considered that the choice of media available to an advertiser was extensive and growing; for example, radio had to compete for its share of revenues with television, newspapers, magazines, outdoor, cinema and new media. This competition was even greater in London: a number of additional media were particularly strong in London, including bus, taxi and London Underground advertising, and most of these were disproportionately important given the greater mobility of London listeners. In Virgin's view, price was a factor at both the planning and the buying stages of an advertising campaign. Over time, said Virgin, it was extremely rare for radio to represent the bulk of an advertiser's expenditure—whilst it might be the primary medium in an individual campaign, radio was generally a secondary medium. In Virgin's case probably 40 to 50 per cent of the briefs it took were understood to involve other media as well as other radio stations.

Buying a campaign

5.45. Capital told us that national advertisers and large local advertisers tended to purchase radio airtime through advertising agencies, whilst small local advertisers tended to buy direct from the radio station. For its part, Virgin told us that it did not compete in the London market per se, since its strategy was to incentivize national advertisers to buy Virgin AM in combination with Virgin FM, leaving two out of nine minutes an hour on Virgin FM specifically for London advertising.

5.46. Virgin also stated that there were almost 10,000 direct advertisers using London only, of which only 666 (6.7 per cent) used radio. Nor was Capital the dominant station for local advertisers. Excluding Virgin FM's 1 per cent, other stations accounted for 68 per cent of London-only radio expenditure.

5.47. Capital said that it was conscious of its responsibilities to service its local area and to offer advertising services to local businesses. It also had an interest in developing its relationship with growing local businesses, as illustrated by the example of Carphone Warehouse, which had 'grown with Capital' from local beginnings into a significant national business. In the case of the London Leopards basketball team (see Chapter 6), Capital explained that it had offered them a co-promotion deal priced at a discount of 50 per cent to its normal spot advertising rates, after taking into account its usual commercial considerations, such as the editorial value of a minority sport on Capital FM and the availability of promotional airtime; it was always open to the London Leopards, alternatively, to book spot airtime through Capital's sales department, but Capital understood that they had never sought to do this.

5.48. Certain 'neighbourhood' advertisers targeting only part of the LSA questioned whether it was appropriate to advertise on Capital. Therefore in this sector of the market Capital competed directly with the local press, outdoor advertising, cinema and smaller London ILR stations. The merger would not prejudice the ability of those neighbourhood advertisers which did not use Capital—and had not been able to use Virgin FM—to continue to use the smaller London ILR stations.

5.49. Capital also drew our attention to cheaper forms of television advertising that had emerged in recent years, on London-focused cable stations such as Channel One and through London-specific sales by Channel 4. These new options represented a growing source of direct competition for radio. We were told that three of Capital's largest direct advertisers were already using London cable television.

5.50. Capital told us that national advertising accounted for around 80 per cent of its total advertising revenues. Whilst this was a profitable area for Capital, it was also the most competitive as it was subject both to the top agencies' buying power and to competition from other media. Virgin said that the substantial power of the purchaser was one of the most important points it wished to make to us—over half of its advertising revenue came from ten of the top 20 largest agencies in the UK, and almost one-third from just three of these, each of whose billings alone exceeded the total billings of all commercial radio stations combined. Just one part in a thousand (0.1 per cent) of Virgin's advertising business came directly from local advertisers, mostly based in London.

5.51. Capital stated that in the year to June 1997 the top 15 agency groups accounted for 55 per cent of all display advertising revenue. In addition, further consolidation was currently taking place among the top groups and the larger agencies had tended to form internal media-buying groups responsible for buying media on behalf of the agency's clients. The buying power of agencies and their clients was increasing as a result of greater comparability of cost-effectiveness across media and agencies' use of their growing experience of historical prices when negotiating new deals; indeed, the media auditors that had for some time monitored television and the press had lately also turned their attention to radio. In these circumstances the balance of advantage in price negotiation tended to lie with the purchaser, not the radio station. Furthermore, the radio station had nowhere to sell its airtime other than to the agency or advertiser, whereas the purchaser could always take business elsewhere and in practice often did so, or readily threatened to do so.

5.52. Capital provided us with information which it believed demonstrated a high degree of cross-advertising between its London stations and the *Evening Standard;* it also submitted that high price correlation between Capital FM and the *Evening Standard* underlined this keen competition (see paragraphs 4.91 to 4.93 and 4.95 to 4.97). It stated that, of its top ten product advertising categories in London, seven were also among the *Evening Standard*'s top ten categories. Moreover, of the top ten advertisers within each of its top ten product categories, the majority also used the *Evening Standard*. Advertisers using both media in the 12 months ending June 1997 accounted for some 60 per cent of Capital's annual revenue, but only some 47 per cent of the *Evening Standard*'s annual revenue, making Capital's position considerably more vulnerable than the *Evening Standard*'s.

5.53. Capital submitted that a continuing difficulty faced by radio in bidding to be included in, or take a bigger share of, a multimedia campaign was that of proving the marginal benefit of using radio. Radio as an advertising medium had yet to achieve the level of confidence enjoyed by television and the press. As a result, radio stations' principal task remained that of overcoming customer scepticism. Radio executives recognized that the degree of substitutability that had worked for them since 1992 was capable of working against them if they did not continue to act in customers' interests.

5.54. Capital commented that even where radio was used as a primary medium it was vulnerable to competition from other media. Consumers' choice of radio station or magazine often reflected their particular tastes and lifestyle and as a result consumer magazines were prime competitors for youth or special interest audiences. In addition, there was an increasing trend towards fragmentation of television audiences, with the introduction of more focused satellite and cable channels which, already, were proving attractive to some of Capital's national advertisers. Of Capital's current top 50 advertisers, 98 per cent also used other media in London and 100 per cent had used at least one other radio station in the last 12 months.

5.55. Virgin told us that although, at the buying stage, price was particularly important when comparing radio stations, this did not necessarily mean that the intermedia choice made in favour of radio at the planning stage was irrevocable. It gave us a number of examples of customers switching between Virgin and other media at the buying stage. These amounted to, on average, some 25 per cent of the total number of campaigns that Virgin was involved in negotiating each month. Virgin also provided us with overall details of its top 50 advertisers' substitutional expenditure over a two-year period between television, press, outdoor and radio.

Advertising prices

5.56. We asked Capital and Virgin what the likely effect of the merger on advertising prices would be if radio were to achieve its objective of perhaps an 8 per cent share of display advertising revenue by around 2010, given the levelling off of total London audiences which they had described and the steady increases in price that they had achieved in the last few years. They pointed out that, whilst total London radio listening was expected to remain at or around its present level, supply to advertisers would nevertheless be augmented in two ways. First, total listening to commercial radio would be increased through Virgin FM's growth predominantly at the expense of the BBC rather than of other ILR stations. In addition, Capital projected audience increases for both Xfm and Heart. Secondly, the separation of Virgin FM from Virgin AM would increase the maximum minutage an hour available to London advertisers from two to nine minutes (see paragraphs 3.26 and 3.49), in common with Capital's other stations.

5.57. Capital said that these increases in available supply to advertisers would inevitably have a deflationary effect on prices, enabling it to contain price increases to a level which it believed would be acceptable in the display advertising market. In particular, the current two minutes an hour for London advertisers on Virgin were heavily demanded and priced accordingly; once the full nine minutes were made available the excess demand would be satisfied, allowing prices to ease. Capital's management projections showed below-inflation price increases in the first two years, followed by marginal real price increases in years three and four as audience growth began to come through.

5.58. Virgin commented that its current policy of restricting the supply of London-only minutage on Virgin FM to two minutes an hour had kept demand high and so enabled it to maximize its prices in London, provided always that these remained competitive with other media. Capital's release of an additional seven minutes an hour would be of benefit to both national and London advertisers. It would make radio more accessible for the many London advertisers not currently using radio (see paragraph 5.46) while at the same time, in combination with the airtime newly made available by Xfm, increasing by almost one-quarter the capacity for existing London radio advertisers among the higher-priced alternatives to Capital FM. More generally, Virgin also believed new delivery methods such as DAB would be instrumental in growing radio's share of display advertising; and that there was scope for the radio industry as a whole to move the level of its pricing closer to that of television, as had happened, for example, in the US market.

5.59. Capital and Virgin submitted that radio was particularly vulnerable to substitution on the basis of price. If Capital were to raise the relative prices of advertising on Capital or Virgin radio stations after the merger without adding commensurate value in terms of wider and more focused coverage to the advertiser, customers would readily give more or all of their radio budgets to other media or to other radio stations, either immediately or when the advertiser planned its next campaign. As long as radio wished to increase its share of display advertising and to enhance its position as a secondary medium it was vital to ensure that it remained a cost-effective medium for advertisers. The media-buying industry continued to consolidate into ever more powerful buying points, which went out of their way to demonstrate cost-effectiveness. If Capital did not add value to any price increases, not only would Capital and Virgin lose revenues, but the radio industry as a whole would be damaged.

5.60. Capital sent us copies of responses to a survey of its customers which it had conducted with regard to the price-related substitutability of radio as an advertising medium and their likely reaction to any price increases by Capital or Virgin which they considered unjustified. It said that these reinforced the themes of its case that radio was substitutable on price grounds to a significant degree and that the market would quickly discipline Capital if its stations ceased to give value for money. Customers also recognized that Capital's unconditional disbandment of its wholly-owned national sales house MSM (see paragraph 3.22) significantly reduced Capital's negotiating power in relation to national advertisers in London (where 80 per cent of Capital's revenues came from national advertisers) and across the country. Whereas a sales operation combining MSM with Capital's London stations would control the majority of any national advertiser's potential radio budget, after the acquisition of Virgin and the closure of MSM that would not be the case. Further, customers agreed that London was the most competitive advertising market in the country and they saw a small increase in Capital's share of radio advertising in London as far outweighed by the public interest benefits of the merger. Capital added that the merger was supported by its customers' two main trade bodies, the ISBA and the IPA, as well

as by the radio industry's two main trade bodies, the RAB and the CRCA and the vast majority of its customers and its competitors.

The future of other London ILR stations

5.61. Capital submitted that, the better it succeeded in achieving its main sales objective to increase radio's share of the London display advertising market, the more its competitor stations would benefit; and that, to the extent that demand for advertising resulted in higher prices for Capital and Virgin, competitors too would benefit from increased demand and higher prices. It told us that the vast majority of advertisers now used a number of London ILR stations and that the merger would not materially affect advertisers' increasing ability to achieve their radio advertising objectives by using a portfolio of stations excluding or in combination with Capital. It drew our attention to signed statements from the respondents to its customer survey supporting this. Advertisers were using an increasing number of competitor stations because those stations delivered audiences that they could not reach through either Capital or Virgin FM and the media buyers' sophisticated planning systems had made them readily accessible. The evidence that Capital had been losing share in this way during the last five years was overwhelming.

5.62. Virgin stated that 500 of the 666 London-only advertisers using radio (see paragraph 5.46) had used neither Capital nor Virgin FM. In addition, there were large numbers of national advertisers currently using combinations of up to six stations excluding Capital. Already the newly-launched Xfm had attracted a number of 'blue chip' national advertisers which had previously been customers of Virgin.

5.63. Capital rejected any suggestion that the acquisition of Virgin would confer any additional market power on the enlarged group. Indeed, it said, the combined effect of the merger and the disposal of MSM was a reduced market position for Capital. Even if Capital conceded (which it did not) that it already had market power, Capital pointed out that it had not previously sought to exploit its market position anti-competitively. Recently the RA had confirmed that it had received no complaints about Capital, in particular in relation to the 1996 assurances. Capital had not in the past sought to engage in any price manipulation between its London FM and AM stations. If it sought to use Virgin to manipulate prices to the detriment of competing stations, customers would simply eschew Capital and buy from Virgin or its competitors; if necessary, smaller local advertisers, which were very attuned to the value of their advertising pound, could turn to other stations or other media, such as local press. Capital believed that to act against the interests of its competitors would ultimately also be contrary to the interests of its customers; failed radio stations would undermine the market as a whole. Virgin commented that pricing Virgin FM low would be a dangerous strategy for Capital to adopt, as it would be years before Capital would be able to take prices back up and the market would question the higher level of prices charged for Capital's FM and AM stations.

5.64. Capital and Virgin told us that they did not practise conditional selling of advertising on their radio stations and that conditional selling would be quickly spotted by the market if introduced after the merger. Capital said that customers' understanding of this sensitive issue was clearly reflected in its survey findings (see paragraphs 5.60 and 5.61). Virgin told us that its published ratecard set out incentives for customers to buy both of its stations. Capital stated that it offered volume-related discounts to larger purchasers of airtime on its two London stations, pricing each station individually so that the customer would not lose the benefit of the discount on one station if it should subsequently change its mind about advertising on the other.

5.65. Capital observed that respondents to its customer survey had pointed out that Capital had not sought to exploit its market position in the past and that the merger did not confer any additional market power on Capital that would enable it to harm its London competitors. Despite the increases in audience and revenue for Virgin FM expected by Capital, Capital's forecasts for the merged group as a whole showed a declining share of London advertising revenue over the next five years because the growth in Virgin FM would not offset the loss of market share by Capital FM and Capital Gold as the London market, and therefore the revenue to other London stations, grew faster than the revenues to the two Capital stations. By the time that the merger could take place, early in 1998, the share of the

merged group would be [*] per cent and Capital was forecasting this to decline to [*] per cent in 2002.

5.66. Capital also told us that it had had discussions about the proposed merger with a number of its competitors in the London market. London News Radio and stations such as Kiss 100 FM and Jazz supported the merger, it believed, on the basis that it would be good for the advertising market and for customers. The more established radio stations understood the benefits of a competing but consolidating radio sector. The attitude of the newer entrants, such as Xfm, which had been quite vocal in its opposition to the merger, and Heart, was understandable, reflecting their concern to become established. This short-term attitude would give way to long-term business sense over time. For example, Capital said that Xfm now seemed assured that the proposed merger would not damage its launch (which had taken place on 1 September 1997).

5.67. Virgin commented that in an open market situation the ability of the combined marketing and programming resources of Capital and Virgin to make life difficult for competitors might be some cause for concern. However, the RA had extensive powers to ensure fair and effective competition in the market place. Indeed, it had obtained an undertaking from Capital in July not to relaunch Virgin FM during the first few months of broadcasting by Xfm.

Possible benefits of the merger

5.68. Capital and Virgin expressed their firm belief that the proposed merger was not only not against the public interest, but was actively in the public interest. Allied to Capital's proven programming expertise, its professionalism and its financial resources, the creation of a separate, dedicated FM rock music station for London and a reformatted and relaunched national AM station out of the present joint FM/AM programming arrangements would increase and widen listener choice. It would also increase the supply of London advertising minutage for customers to purchase, and grow the audiences accessible to customers; moreover, the additional seven minutes an hour available for London-only advertising would have a deflationary effect on pricing and would be of particular benefit to the many London advertisers not currently using radio. The resulting growth in radio's share of display advertising revenues would help to consolidate the position that radio had begun to achieve in recent years as an established display advertising medium attractive to both national and local advertisers.

5.69. Capital and Virgin also stressed that, in their view, it was vital that there should be an independent radio champion with the critical mass and financial strength to enable it to seize the enormous opportunities presented by the evolution of the digital market place. Owning Virgin would give Capital a natural entry into DAB. With guaranteed entry into the new system, the combined Capital and Virgin group would throw its weight behind DAB, creating a strong indigenous radio company capable of challenging the BBC and bringing significant benefits to the domestic economy by competing effectively at home and abroad with the major US and other foreign-owned international radio companies. If, however, UK radio was prevented from creating such a company, this would effectively hand over the control of UK radio to companies based overseas. The provisions in the 1996 Act relating to digital radio allowed non-EU countries to own radio stations in the UK and many of the large US radio groups were seeking to expand internationally as their own markets matured. The major US groups dwarfed their UK rivals, the biggest of them having revenues greater than those of the entire UK radio industry. The investment required to take part in DAB, whilst potentially prohibitive for UK radio groups, would be insignificant to many US radio groups.

5.70. Capital considered that these public interest benefits would be achievable only as a result of the proposed merger. The scale and riskiness of the investment required to split the Virgin stations and mount a serious challenge to BBC Radio 1 would deter most investors. Capital, however, had the resources to commit significant time and effort to this investment; and for Capital the riskiness was reduced by the synergies arising from the merger and the confidence it had in its superior programming and selling skills. Capital believed it was the only company with the commitment and management resources to launch a serious challenge to the BBC into the digital era.

*Figures omitted. See note on page iv.

Possible remedies

5.71. Capital commented that, whilst it had no intent or history of engaging in any form of anti-competitive behaviour or price manipulation, it recognized the concerns that had been raised during the course of our inquiry. It said it considered that its unconditional disposal of MSM (see paragraph 3.22), together with the following proposals for potential behavioural undertakings, should be sufficient to allay any fears about its position in London radio should the merger go ahead:

(a) an undertaking not to re-enter the third party sales representation business for, say, five years;

(b) an undertaking not to engage in conditional selling;

(c) an undertaking not to offer solus advertising deals; and

(d) an undertaking to provide to the OFT every three months audited pricing data relating to Capital FM, Capital Gold, Virgin AM and Virgin FM for three key customer groups: national advertisers, local advertisers which used advertising agencies and direct local advertisers. For each customer group the price data would set out the overall average CPT, the average CPT for the top ten advertisers and the average CPT for the bottom ten advertisers. Over time, using this information, together with revenue information which Capital would also provide for its individual London stations and the overall UK market, the OFT would be enabled to form an opinion on how prices were moving and whether Capital was either raising prices unjustifiably to its customers or lowering the advertising rates on Virgin FM or another London station to the detriment of its competitors.

5.72. Nevertheless, Capital said that, as a last resort, if a further reduction in its share of London revenues was considered necessary despite the evidence it had provided to the contrary, it believed, if it were to contract out the sales of Capital Gold to a third party independent sales house, this would be sufficient to remedy any perceived adverse public interest consequences of the merger. If required, it would be prepared to consider offering out the contract for the national and local airtime sales of Capital Gold to an independent third party which would have complete control over the sales process, including setting prices and controlling minutage, for five years. The arrangements would be similar to those operated by MSM, involving probably weekly meetings with the sales house to ensure that sales were on target, incentivizing the sales house to exceed its sales targets and a necessary degree of editorial control by Capital's programmers as regards the sale by the sales house of sponsorships and promotions. Capital believed there were a number of parties which would be interested in such a contract.

5.73. [

Details omitted. See note on page iv.

]

5.74. Capital emphasized that Capital FM and Virgin FM were such key parts of the portfolio of the enlarged Capital group that it could contemplate neither their divestment nor the contracting out of their sales. The acquisition of a second FM station in London was the main purpose of the proposed merger. Since this would also drive the success of the merger, and since advertisers were currently accustomed to buying Virgin FM and Virgin AM as a package, it would be commercially sensible for Capital to retain ownership and control of the sales both of the two FM stations and of Virgin AM. Capital added that it doubted whether Virgin Holdings would proceed with the merger on any other basis.

5.75. Virgin commented that any divestment by Capital might, in its opinion, seriously undermine the economics of the merger, in particular by limiting Capital's ability to spread the substantial costs of investing in and developing DAB. With regard to Virgin FM, Virgin said that this had always been jointly operated with Virgin AM and that these two stations bore the same brand name. As such they were inextricably linked. Virgin told us that Virgin Holdings would not sell the two licences separately from each other as to do so would damage the integrity of the Virgin brand. In any event, Virgin doubted whether Capital would wish to proceed with the merger if it could own only one of the two Virgin stations.

Summary

5.76. Summarizing its submissions, Capital highlighted what it saw as the important points, as follows:

(a) *The relevant market was wider than radio.* Radio was substitutable with other media, particularly in London. Evidence provided by Capital clearly demonstrated that a substantial percentage of the wider display market was competitive or substitutable with radio. This evidence included two papers by Case showing a high degree of switching of advertiser spend between radio and other media and a high correlation in price movements between Capital FM and other media, suggesting that prices on Capital were constrained by other media; a paper by Unity demonstrating that intermedia decisions were taken at various stages of campaign planning and execution and showing the important part pricing played; signed statements from customers explaining that radio was part of the wider display advertising market and stating that substitution based on price regularly occurred; and evidence of substitution taken from Capital's day-to-day dealings with advertisers and their agents. Capital's market share required to be calculated on the basis of this wider display market.

(b) *Competition was increasing.* Competition for advertising revenue was increasing continually, both in radio and other media, and particularly in London, where there was a proliferation of media choice. Capital's share of London radio revenue was in long-term decline. The merger with Virgin would not confer on Capital any substantial increase in its share of London radio revenue—in fact the share of the merged group would be below that of Capital one year earlier and was forecast to decline over the next five years.

(c) *Future of other London radio stations.* The other London radio stations would not be adversely affected by the merger because the increased London commercial radio audience as a result of refocusing Virgin FM would increase advertising demand for radio, to the benefit of them all—evidence showed that advertisers were increasingly using a number of radio stations as part of their schedule; the merged group's share of listening and revenue in London did not confer any additional market power and as such could not harm other London radio stations; Capital had no history or intention of using its position to manipulate prices or to practise conditional selling—Capital's number one objective was to increase radio's share of advertising revenue and Capital believed that any attempt to manipulate the market would be noticed by its customers and would ultimately result in advertisers substituting other media for radio.

(d) *Support for the merger.* Capital had received the support of the majority of its customers and competitors and also the support of the advertisers' two main trade bodies (the ISBA and the IPA) and radio's two main trade bodies (the CRCA and the RAB).

(e) *Public interest benefits of the merger.* It was Capital's firm belief that the proposed merger was not only not against the public interest, but was actively in the public interest; the public benefits of the merger were those outlined in paragraphs 5.68 to 5.70.